2019 Investment Outlook:
Back to "reality"

December 2018

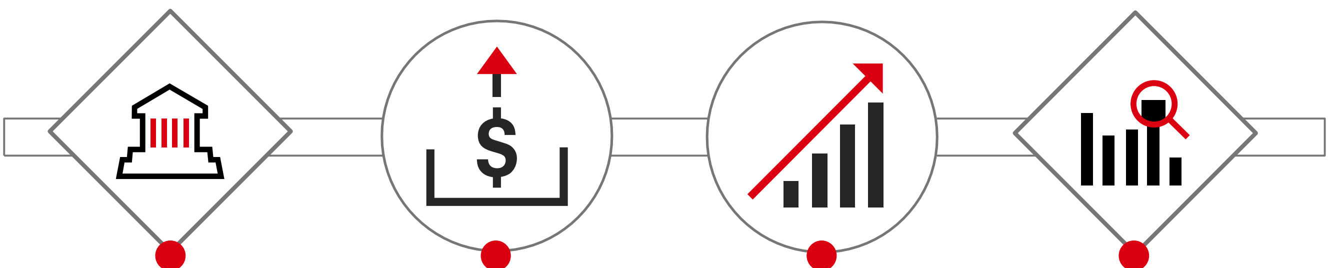
HSBC
Global Asset
Management

What happened in 2018 in markets and the economy?

2018 has been a tricky year for investors:

- Performance is either flat or negative across most asset classes, with only a few exceptions
- Some asset classes like emerging markets have performed really poorly
- Returns were poor even on traditional diversifying asset classes such as US treasury bonds and gold There have been few safe havens
- But, after a stellar 2017, perhaps this was to be expected

There has been a lot of noise in financial markets in 2018, and this generated episodes of volatility (i.e. fluctuation in investment returns). However, overall volatility is still low compared to history. To understand, we need to focus on the key themes:



Strong economic growth in the US versus a slowdown in the other economies of the world pushed up US interest rates.

This caused the US dollar to appreciate.

It's the combination of these factors that has mattered: higher US interest rates, stronger dollar, weaker than expected growth in the rest of the world.

The US dollar rose most significantly and abruptly against emerging market currencies.

It's the weakest emerging markets that have fared the worst.

Those with stronger macro characteristics have fared better.

But it's not all bad news...

The long-term investment performance of equities – say over 10 years – still looks very impressive.[1]

But we do need to be thoughtful about what that implies for prospective investment returns going forward

The other piece of good news is that global corporate profits continue to look good to us.

For example, equity markets are now cheaper and profit delivery remains good.

So, although we find ourselves in a relatively low return world, we think there are some good opportunities.

Investment involves risk. Past performance is not a reliable indicator of future performance.

[1] Source: The MSCI All Country World Index has returned 9.7% per annum over cash over last ten years, as at 31 October 2018.

What are the key economic themes as we head into 2019?

Back to a more normal environment – "back to reality"

- Global economic growth has slowed, and we think it's now on trend with its long-term average pace.[2]
- So it feels a bit different from the synchronised growth that we had in 2017, but we think it's certainly no disaster.
- And we believe that concerns about an imminent recession are misdirected.

Monetary policy has moved back to neutral

- US fiscal stimulus – an important driver of US growth in 2018 – is now set to fade.
- Federal Reserve (Fed) policy is moving back into neutral gear too. Other central banks are a bit behind, but going in the same direction.
- By contrast, in China, policy stimulus should support stronger economic activity in 2019.
- Meanwhile, global inflation is creeping higher, but we expect it to remain contained overall in 2019.

The global economy is running on two engines

- The two engines of growth are China and the US.
- It's the outlook for these two engines that will be really important for determining the path of the economy in 2019.

What does it mean for our investment views generally?

A number of growth-sensitive asset classes have become significantly cheaper over 2018, and we think they now offer good value – especially Asian equities and emerging market equities. In multi-asset portfolios, we also think there is value in some US Treasuries, especially compared to European government bonds. And the improvement in the market value of US bonds during 2018 also means that we have the opportunity to buy more defensive asset classes at better prices, to help us diversify.

What are the biggest risks looking forward?

The risk with the biggest potential impact is US inflation. Faster-than-expected US inflation would force bond yields higher and undermine asset-class valuations. So far, inflation trends seem to be subdued. But we need to be vigilant about this.

The second key risk is that a further escalation of the trade war could impact China, Asian economies and the global system. The good news is that this risk is already well-known to the market and financial market prices already reflect the probability of this happening.

Investing is not without risk, and the value of investments can go down as well as up. In the current environment, several possible risks stand out in particular. The key thing will be to take an active approach to our asset allocation.

Given the macro backdrop today, it's important to be diversified, to be willing to ride out phases of volatility, and to be adaptive to any changes in the environment. We think it is "back to reality" in 2019.

[2] Source: HSBC Global Asset Management Nowcast – global trend growth (the 5-year average) is 3.2%. Data as at 31 October 2018.

We want to "back growth" – but at a reasonable price

Multi-asset outlook

The way that we build our asset allocation views relies on our analysis of what current market prices are already taking into account. This is called a valuation analysis. We also track macroeconomic fundamentals and our own economic measures, and combine these with our valuation analysis.

Based on this, we think there are three key multi-asset themes as we enter 2019: "growth at a reasonable price"; "is perceived safety 'safe'?"; and "portfolio resilience".

What do we mean by "growth at a reasonable price"?

We think the global economy is in pretty good shape – and that worries about a growth slowdown or recession are over-played, especially when we look at the continued good trends in corporate profits.[3]

Meanwhile, a number of growth-sensitive asset classes have become significantly cheaper during the course of 2018, and now offer good value on a tactical basis. We think this is particularly the case for Asian equities and emerging market equities, where currencies and equity markets have cheapened significantly. Because we think the economy is in good shape, we want to take those opportunities.

Some bonds look interesting to us as portfolio diversifiers

So is perceived safety "safe" again?

Over the last couple of years, bonds have been a poor source of diversification for multi-asset portfolios, meaning they haven't shielded portfolios from the markets' episodic volatility, or fluctuations. Now, for the first time since 2016, because of the rise in US interest rates this year, some US Treasuries finally look more interesting to us as portfolio diversifiers.

Risks remain – for example if inflation trends build or if the market starts expecting stronger inflation. That's not what we expect, but we need to monitor that scenario closely and we certainly can't rule it out.

But for now, in multi-asset portfolios, we think there is value in parts of US Treasuries, especially compared to European government bonds.

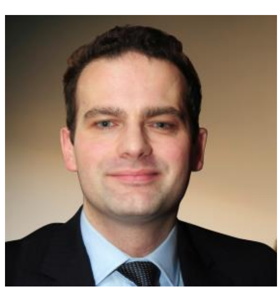
We see an opportunity to buy more defensive asset classes at better prices

And what does "portfolio resilience" entail?

The improvement in US bond valuations during 2018 also means that we have the opportunity to buy more defensive asset classes at better prices.

This is attractive to us because we can add "portfolio resilience" against more adverse scenarios that could develop in the economy (for example the risk of higher interest rates). Again, we would focus on US bonds – especially short-duration[4] parts of US Treasuries and also some short-duration[4], higher-quality corporate bonds.

For us, this is an opportunity to get some attractive-looking diversification into our multi-asset portfolios.



Joseph Little

Global Chief Strategist
HSBC Global Asset Management

[3] Global average net profit margins: 8.2% year-to-date, as at 31 October 2018. Source: HSBC Global Asset Management, Bloomberg.
[4] Short-duration bonds are bonds with a life of less than five years.

We prefer emerging markets where companies have stayed resilient

We especially like China, broader Asia and Europe

Equities outlook

What happened in 2018?

2018 has been a very challenging year for equity investors. The year started off strongly, but the tide turned towards the end of the first quarter, with equity markets, especially in emerging economies, falling victim to geopolitical and macroeconomic concerns.

While many of these concerns did not pan out in the way investors feared they would, they have nevertheless been a key factor in equity markets this year. The majority of investors have been focused on them rather than on macroeconomic and corporate fundamentals, which have actually held up well through the year.

How do you see next year for equities?

Although investor fears seem to have won over fundamentals in 2018, we think the situation could reverse in 2019.

First, fundamentals have gotten stronger because equities are now more profitable, almost everywhere around the world, and as a result they look less expensive.

Second, some of the macroeconomic factors which have taken up so much of investors' attention seem likely to be less of a focus going into 2019.

What does this mean in terms of investment opportunities?

For 2019, we see a number of interesting opportunities – especially in some emerging markets, which look a lot cheaper after the indiscriminate sell-off in 2018.

It's important to understand that "emerging markets" is a generic term for a host of very different economies. The ones we currently prefer are those where companies have stayed resilient and performed strongly.

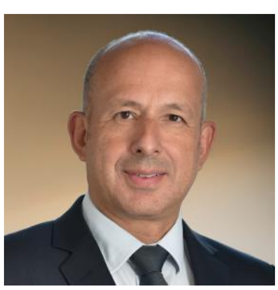
Among those, we especially like China. We think the Chinese economy has held up well despite concerns around growth and trade tensions and that, as these concerns fade, it could support Chinese stocks next year.

We also like the broader Asian equity market. It remains quite a bit cheaper than other global markets. And its economies have stayed resilient in an increasingly challenging environment.

Elsewhere, we are positive on Europe. It has not fared very well either this year, despite improving corporate earnings and cheap valuations so, for discerning investors, we think it can offer some opportunities in 2019.

And what are the key risks for equities?

The key risks for our outlook on equities next year are: first, if the US Federal Reserve had to raise interest rates sharply; and second, the trade tensions between the US and China, and the risk this creates for Chinese growth. We will be keeping a close eye on both situations throughout next year.



Bill Maldonado

Global CIO Equities
HSBC Global Asset Management

We think the environment is supportive for positive bond returns in 2019

We especially like short-duration segments, but being selective will be essential

Bonds outlook

What happened in the main bond markets in 2018?

In contrast to 2017, bond markets have posted negative returns this year, with a few exceptions.

There are several causes: economic growth has not been quite as strong, and trade tensions between the US and China have been an ongoing concern for investors. Monetary policy has also been tighter (for example, the US Fed will have raised interest rates four times by the end of the year). This combination, in conjunction with geopolitical uncertainty like Brexit, caused episodes of volatility in the markets.

Bonds in emerging markets also posted negative returns. They suffered from the sharp rise in the US dollar and trade tensions. Later in the year, their economic growth slowed a little, which hurt performance too.

How do we see 2019 for bonds?

We expect the global environment to go "back to reality", but we believe it could be more positive for global bonds, for three reasons:

- US economic growth could slow down a bit, putting less pressure on the Fed to continue raising interest rates – though a spike in US inflation remains a key risk
- We don't think economic risks like trade tensions will worsen
- Bond valuations have improved, so investors are better rewarded for taking the risk in some categories of bonds

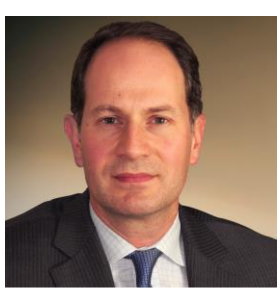
In these conditions, we think bond markets should post positive – if volatile – returns in 2019, and we see opportunities across markets. We especially like short-duration[5] segments, for instance in US investment-grade or higher-risk corporate bonds, or in European periphery government bonds like Spain or Italy.

But although we like corporate bonds, as the credit cycle progresses, i.e. the cycle of expansion and contraction of access to credit, we want to focus on the best-quality higher-risk bonds, and to continue being extremely careful in our selection. Similarly, we are positive on emerging markets, especially Asia, but with very careful selection – particularly country selection, where we think individual vulnerabilities will be a major driver of currency movements and returns.

What are the key risks to our outlook for bonds?

Financial markets are facing a lot of uncertainty going into 2019 – on global growth, geopolitical risks, and long-term trends like ageing populations or the environmental transition.

In this uncertain context, there are two main risks to our outlook, to which we will be paying particular attention: first and foremost, the risk of a sharp Chinese slowdown; and second, the risk of an inflation spike in the US putting pressure on the Fed to raise rates faster.



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[5] The part of the bond market that is generally less sensitive to rising interest rates.


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